

Once Upon a Time... of Fed Easing

A Publication of BMO Capital Markets Economic Research • Douglas Porter, CFA, Chief Economist, BMO Financial Group

The Fed is almost universally expected to clip interest rates at next week's FOMC meeting, with most of the lingering debate now over the size of the first step, and whether it will be accompanied by any additional measures. For the record, **we lean to a simple 25 bp trim to start**, but readily recognize that the Fed has surprised many times on the easier side of the ledger so far in 2019. Looking beyond next week's moves, the more interesting question is **what comes next —will this be just the first in a series of cuts, how long will the easing cycle last, how might markets respond, and when could the Fed realistically begin hiking again?** To address these issues, and many others, let's look back at past easing cycles.

Below, in Tables 1 and 2, we consider the 12 separate and distinct easing cycles that can be identified over the past fifty years (*Chart 1*). Because rates were so volatile in the 1970s and 80s, and there were numerous mini cycles, we used changes in the discount rate to identify the start and end points of easing cycles for much of those two decades (and the Fed funds rate after the mid-80s). We have further split the easing cycles into mini and major cycles, with those with less than 100 bps of total easing placed in the first category (the shaded rows). The only one of the 12 which falls somewhere in between is the very first one in 1970/71, but it just qualifies as a major cycle (at 125 bps of easing from a starting point of 6.0%). Easing cycles are deemed to officially end only after the last rate cut before they started moving higher again.

There are a few major conclusions which jump out. First, the easing cycle itself:

- Exactly half of the 12 easing cycles started with a 25 bp trim, four with a larger 50 bp move, and two with a full 100 bp cut (both the early 1980s cycles, when rates were starting in the double digits).
- Full easing cycles have been as small as 50 bps (1971), and as large as 681 bps (1989-92). As a share of the starting rate, mini cycles have seen net cuts of little more than a tenth, while major easing cycles have been as moderate as a 21% slice, all the way up to almost a 100% cut (in the 2007-08 financial crisis).
- In terms of duration, half of the cycles have been done in six months or less, while the 1989-92 cycle dragged on for more than three years. A "normal" major easing cycle lasts about 18 months.

ECONOMIC RESEARCH
1-800-613-0205
economics.bmo.com

Douglas Porter, CFA, Chief Economist
+1 (416) 359-4887
douglas.porter@bmo.com

Chart 1
12 Easing Steps

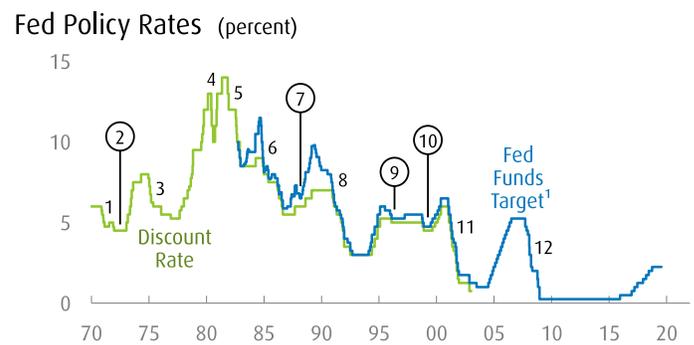


Table 1
Twelve Easy Steps: Part One

	Start of Fed Easing Campaign	Starting Rate (%)	First Cut Size (bps)	Total Cuts	Last Cut	Easing Cycle (months)	Next Hike	Time Gap (months)
Discount Rates								
1	Nov. 13, 1970	6.00	25	125	Feb. 1971	3	July 1971	5
2	Nov. 19, 1971	5.00	25	50	Dec. 1971	2	Jan. 1973	13
3	Dec. 9, 1974	8.00	25	275	Nov. 1976	23	Aug. 1977	9
4	May 30, 1980	13.00	100	300	July 1980	3	Sep. 1980	2
5	Nov. 2, 1981	14.00	100	550	Dec. 1982	13	Apr. 1984	16
6	Nov. 21, 1984	9.00	50	250	Aug. 1986	21	Sep. 1987	13
Fed Funds								
7	Nov. 4, 1987	7.31	50	81	Feb. 1988	4	Mar. 1988	1
8	June 6, 1989	9.81	25	681	Sep. 1992	39	Feb. 1994	17
9	July 6, 1995	6.00	25	75	Jan. 1996	6	Mar. 1997	14
10	Sep. 29, 1998	5.50	25	75	Nov. 1998	3	June 1999	7
11	Jan. 3, 2001	6.50	50	550	June 2003	29	June 2004	12
12	Sep. 18, 2007	5.25	50	513	Dec. 2008	15	Dec. 2015	84
Median	Mini cycles	5.75	25	75		4		10
	Major cycles	8.50	50	406		18		13
July 2019		2.38	25?	50?		4?		

Shading marks mini easing cycles

Table 2
Twelve Easy Steps: Part Two

	Start of Fed Easing Campaign	Jobless Rate		S&P 500 (% chng)		10-yr Treasury Yield (bps)		First Cut	Full Easing (% of starting rate)
		At Start (%)	vs. 6 Mo. Prior (ppts)	6 Months Prior	6 Months After	6 Months Prior	6 Months After		
Discount Rates									
1	Nov. 13, 1970	5.5	0.9	10.5	20.8	-86	-93	4.2	21
2	Nov. 19, 1971	5.8	-0.1	-9.6	18.3	-70	33	5.0	10
3	Dec. 9, 1974	6.6	1.5	-29.1	40.3	-6	19	3.1	34
4	May 30, 1980	6.9	0.9	4.1	27.4	-9	248	7.7	23
5	Nov. 2, 1981	7.9	0.7	6.9	16.3	52	-68	7.1	39
6	Nov. 21, 1984	7.4	-0.3	-6.4	-4.2	111	171	5.6	39
Fed Funds									
7	Nov. 4, 1987	6.0	-0.3	-15.7	3.8	40	-1	6.8	11
8	June 6, 1989	5.2	-0.1	16.8	6.6	-59	-42	2.6	69
9	July 6, 1995	5.6	0.1	20.2	11.3	-177	-36	4.2	13
10	Sep. 29, 1998	4.5	-0.1	-4.1	25.4	-108	68	4.6	14
11	Jan. 3, 2001	3.9	-0.1	-12.7	-6.3	-108	25	7.7	85
12	Sep. 18, 2007	4.6	0.3	8.4	-9.9	-8	-100	9.6	96
Median	Mini cycles	5.7	-0.1	-6.9	14.8	-89	16	4.8	12
	Major cycles	6.1	0.5	5.5	11.5	-9	-12	6.4	39
July 2019	(data as of July 26)	3.7	-0.2	14.2		-67		10.7	21?

Shading marks mini easing cycles

- As Table 2 shows, the easing cycles have typically begun at a higher jobless rate (averaging almost 6%), but it hasn't always been rising in the six months prior to rate cuts. In fact, ahead of the four mini easing cycles, the jobless rate had typically been flat-to-down in the lead-up to the rate cuts (as is the case in the current episode).

Second, how the markets react:

- Perhaps the single biggest takeaway from past easing cycles is that equities have tended to rise six months after the rate cuts began while bond yields have been nearly flat on average—both in mini and in major easing cycles. In 7 of the 12 cycles,

the S&P 500 has posted double-digit advances in the following six months. However, note that the two most recent cycles have run against that grain.

- Bond yield outcomes have been much less one-sided, with no clear tendency to rise or fall in the six months following the first cut in either mini or major cycles. Again, note that the biggest exception was the most recent cycle in 07/08.
- Both stand in contrast to market moves in the lead-up to the first rate cut, where stocks have been mixed on average in the six months before the easing cycle began. That may run a bit counter to perceptions, as there were some dramatic episodes of deep declines (which in at least one case was the main driver of Fed easing (1987)). But there have also been a number of easing cycles that began with equities in strong shape, as is clearly the case in 2019.
- The recent deep drop in bond yields also lines up reasonably well with the majority of past easing cycles—9 of the 12 saw yields falling (often heavily) in the six months prior to the first rate cut. Indeed, the slide in Treasury yields this year is quite close to the median drop seen over the past 12 easing cycles.

We believe that this will ultimately be a mini easing cycle, officially calling for just one more move in October, although the market is priced for roughly 100 bps of cuts over the next year. The **deciding factor** for whether the rate cuts morph into a major cycle, not surprisingly, will be **how the underlying economy fares** in the next 6-12 months. While financial markets have tended to react in a reasonably uniform fashion after the start of easing cycles, the economy has not—in the four mini cycles, the jobless rate was slightly lower in the six- and 12-months after rate cuts began. However, in the cycles that morphed into major rate cut campaigns, the jobless rate was half a point *higher* six months after the first cut on average, and was almost a full point higher one year later. At this point, we are projecting just a 0.1 ppt increase in the jobless rate a year from now, and thus only modest rate trims; but we are also assuming no further deterioration in the trade wars.

Looking beyond this year's expected rate cuts, if this does indeed remain a mini easing cycle, past episodes suggest that the Fed could conceivably be *hiking* rates again by late next year or early 2021. **The typical easing cycle**—both mini and major—**has seen the Fed begin to tighten again within roughly a year of the last rate cut**. Again, the glaring exception to the rule was the most recent cycle, when the Fed was forced to wait seven long years between the last rate cut in 2008 and the first rate hike in late 2015.

Bottom Line: There is no foolproof fixed playbook for Fed easing cycles, as every episode has its own quirks and special features. And there are some unusual aspects to the beginning of this Fed easing cycle—the extreme low starting level for both the jobless rate and interest rates. But, there are also many features that rhyme with historical precedent. Market behaviour has been close to the norm heading into easing campaigns, as has the trend in the jobless rate, at least compared with mini easing cycles... which this one is expected to mirror.

Coda: It may seem a tad surprising that the Fed is poised to ease just a bit more than 7 months after the December 19 rate hike. Yet, in the 12 easing cycles studied above, the median spread between the last rate hike of the prior tightening cycle and the first rate cut of the next was just 7 months (with a range of 1 to 18 months). So, from that standpoint at least, this cycle looks to fit the playbook perfectly.

General Disclosures

"BMO Capital Markets" is a trade name used by the BMO Financial Group for the wholesale banking businesses of Bank of Montreal and its subsidiaries BMO Nesbitt Burns Inc., BMO Capital Markets Limited in the U.K. and BMO Capital Markets Corp. in the U.S. BMO Nesbitt Burns Inc., BMO Capital Markets Limited and BMO Capital Markets Corp are affiliates. This document is issued and distributed in Hong Kong by Bank of Montreal ("BMO"). BMO is an authorized institution under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong) and a registered institution with the Securities and Futures Commission (CE No. AAK809) under the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong). BMO does not represent that this document may be lawfully distributed, or that any financial products may be lawfully offered or dealt with, in compliance with any regulatory requirements in other jurisdictions, or pursuant to an exemption available thereunder. This document is directed only at entities or persons in jurisdictions or countries where access to and use of the information is not contrary to local laws or regulations. Their contents have not been reviewed by any regulatory authority. Bank of Montreal or its subsidiaries ("BMO Financial Group") has lending arrangements with, or provide other remunerated services to, many issuers covered by BMO Capital Markets. The opinions, estimates and projections contained in this report are those of BMO Capital Markets as of the date of this report and are subject to change without notice. BMO Capital Markets endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Capital Markets makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Capital Markets or its affiliates that is not reflected in this report. The information in this report is not intended to be used as the primary basis of investment decisions, and because of individual client objectives, should not be construed as advice designed to meet the particular investment needs of any investor. This document is not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such Information be considered as investment advice or as a recommendation to enter into any transaction. Each investor should consider obtaining independent advice before making any financial decisions. This document is provided for general information only and does not take into account any investor's particular needs, financial status or investment objectives. BMO Capital Markets or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO Capital Markets or its affiliates, officers, directors or employees have a long or short position in many of the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should assume that BMO Capital Markets or its affiliates may have a conflict of interest and should not rely solely on this report in evaluating whether or not to buy or sell securities of issuers discussed herein.

Dissemination of Research

Our publications are disseminated via email and may also be available via our web site <https://economics.bmo.com>. Please contact your BMO Financial Group Representative for more information.

Conflict Statement

A general description of how BMO Financial Group identifies and manages conflicts of interest is contained in our public facing policy for managing conflicts of interest in connection with investment research which is available at http://researchglobal.bmocapitalmarkets.com/Public/Conflict_Statement_Public.aspx.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

BMO Financial Group (NYSE, TSX: BMO) is an integrated financial services provider offering a range of retail banking, wealth management, and investment and corporate banking products. BMO serves Canadian retail clients through BMO Bank of Montreal and BMO Nesbitt Burns. In the United States, personal and commercial banking clients are served by BMO Harris Bank N.A., Member FDIC. Investment and corporate banking services are provided in Canada and the US through BMO Capital Markets. BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking businesses of Bank of Montreal, BMO Harris Bank N.A., BMO Ireland PLC, and Bank of Montreal (China) Co. Ltd. and the institutional broker dealer businesses of BMO Capital Markets Corp. (Member SIPC), BMO Nesbitt Burns Securities Limited (Member SIPC) in the U.S., BMO Nesbitt Burns Inc. (Member Canadian Investor Protection Fund) in Canada, Europe and Asia, BMO Capital Markets Limited in Europe, Asia and Australia and BMO Advisors Private Limited in India. "Nesbitt Burns" is a registered trademark of BMO Nesbitt Burns Inc., used under license. "BMO Capital Markets" is a trademark of Bank of Montreal, used under license. "BMO (M-Bar roundel symbol)" is a registered trademark of Bank of Montreal, used under license.

© Registered trademark of Bank of Montreal in the United States, Canada and elsewhere.

™ Trademark Bank of Montreal in the United States and Canada.

© COPYRIGHT 2019 BMO CAPITAL MARKETS CORP.

A member of BMO Financial Group